STATEMENT SUPPORTING THE CONDUCT STANDARD – CONDITIONS FOR INVESTMENT IN DERIVATIVE INSTRUMENTS FOR PENSION FUNDS

DATE OF ISSUE: 11 May 2023

FSCA

Financial Sector
Conduct Authority

1. PURPOSE OF THE STATEMENT

1.1 This Statement relates to the publication by the Financial Sector Conduct Authority (the Authority) of the Conduct Standard 1 of 2023: *Requirements Related to Investments in Derivatives by Pension Funds* (Conduct Standard). The Authority intends to make Conduct Standard under section 106(1) of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSR Act).

1.2 This Statement is published in accordance with section 98(1)(a) of the FSR Act and is intended to give support and context to Conduct Standard. The Statement explain the need for, the expected impact of, and the intended operation of the Conduct Standard.

2. STATEMENT OF NEED - POLICY CONTEXT AND PROBLEM DEFINITION

2.1 Derivative instruments in a pension fund can be used for a variety of purposes. According to the IOPS *Pension Fund Use of Alternative Investments*, basic derivative contracts can be used by pension funds to hedge their risk exposure to specific financial instruments, both on the asset and liability side.[1] Further, derivatives can also be used to change the characteristics of the fund's portfolio investments, such as the duration of the fixed income portfolio.

2.2 The Authority recognises that there is a role for the use of derivatives within pension funds' portfolios, however there are a number of major risks inherent in these instruments. Three major risks with the use of derivatives are market transparency, counterparty risk and liquidity risk. Such investments are often complex, illiquid or opaque, and therefore require close monitoring, analysis and intrusive supervision than most traditional investment products. This is more so when potentially vulnerable investors, such as pension fund members and beneficiaries, are involved.

2.3 Regulation 28(7) provides that funds may invest in derivative instruments and empowers the FSCA to prescribe conditions in respect thereof. However, to date no conditions have been prescribed for funds when investing in derivative instruments.

2.4 Therefore, there is a need to prescribe conditions for investment in derivative instruments by pension funds to mitigate the risks referred to in paragraph 2.2.

3. SUMMARY OF CONDUCT STANDARD

3.1 In order to balance the benefit with the possible risks associated with investing in derivative instruments, the Authority deems it appropriate to prescribe conditions for pension funds when investing in derivative instruments as part of its investment strategy.

3.2 The Conduct Standard sets out overarching principles for the uses of derivative instruments by funds.

3.3 The Conduct Standard also sets conditions relating to, amongst other things, the following –

(a) permissible uses of derivative instruments;
(b) net derivative positions must at all times be covered by appropriate reference assets;
(c) valuation of derivative instruments;
(d) determining the allowable counterparties for purposes of derivative instruments;

[1] IOPS (2011), *"Pension Fund Use of Alternative Investments and Derivatives: Regulation, Industry Practice and Implementation Issues", IOPS Working Papers on Effective Pension Supervision*, No. 13.

(e) providing guidance on the calculation of exposure to derivative instruments;
(f) setting out the allowable netting provisions for derivative instruments;
(g) determining the conditions in respect of collateral; and
(h) prescribing the conditions for reporting.

4. STATEMENT OF IMPACT OF THE CONDUCT STANDARD

4.1 Commentators were of the view that some of the requirements will result in additional costs such as the underlying of the derivative instruments would have to be reported more strictly by asset managers and require additional resources. One commentator was of the view that the Conduct Standard will result in compliance requiring significant systems development to ensure adherence and sufficient time should be granted. Commentators did not provide quantitative data or estimations of the expected increase in costs.

4.2 The Authority, agrees that the Conduct Standard will in some instances result in increased costs, especially because of system and process changes that could potentially be necessary. The Authority is therefore of the view that the envisaged additional costs are justified taking into account the expected positive outcomes that will be achieved through the implementation of the Conduct Standard.

4.5 In terms of reporting, commentators raised concerns, amongst others, Regulation 28 reporting to the Authority; alignment with SARB i.e. misalignment between the SARB's treatment of derivatives (physical) and Regulation 28's treatment of derivatives (effective); conflation of effective economic exposure and counterparty risk; and treatment of notational adjustment during reporting.

4.6 The Authority will in due course issue revised Annual Financial Statement notes and updated Regulating Reporting Requirements (accounting framework) for public comment. It is expected that the implementation of the updated reporting frameworks will address the reporting issues.

5. STATEMENT OF INTENDED OPERATION OF THE CONDUCT STANDARD

5.1 The Conduct Standard is consistent with the objectives of the FSR Act, and specifically the mandate of the Authority to protect the interests of members of funds and ensuring financially sound pension funds.

5.2 Some commentators requested that funds should have an appropriate time period after the publication of the requirements to review their current policies, processes, and procedures to ensure compliance with the requirements set by the Conduct Standard. It was contended that whilst most of the requirements are similar to current market practice, the operational capacity of industry participants to implement reviewed or new requirements are constrained mostly by alternative working arrangements implemented in response to the Covid-19 pandemic. Accordingly, commentators requested a longer implementation period.

5.3 In terms of implementation, the Authority believes that the proposed transitional period of 12 months is sufficient to facilitate timeous implementation of any new requirements contained in the Conduct Standard.

5.4 As such, the Conduct Standard will come into operation within 12 months after publication thereof. The Authority believes this should afford funds sufficient lead time to implement measures to ensure compliance with the Conduct Standard. Following the implementation of the Conduct Standard, the Authority will assess and evaluate the effect of the Conduct Standard on a continuous basis as part of its regulatory and supervisory responsibilities.